



Response: Proposed Rulemaking for Amendments to the Regulatory Capital Rule Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (the “Basel III Endgame” proposal), and to Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies (the “GSIB Surcharge” proposal)

## Background

Established in 1961, the World Federation of Exchanges (WFE) is the global industry association for exchanges and clearing houses (CCPs). Headquartered in London, it represents over 250 market infrastructure providers, including standalone CCPs that are not part of exchange groups. Of our members, 34% are in Asia-Pacific, 45% in EMEA, and 21% in the Americas.

The WFE's 90 member CCPs and clearing services collectively ensure that risk takers post some \$1.3 trillion (equivalent) of resources to back their positions, in the form of initial margin and default fund requirements. WFE exchanges, together with other exchanges feeding into our database, are home to over 50,000 listed companies, and the market capitalisation of these entities is over \$100 trillion; around \$140 trillion (EOB) in trading annually passes through WFE members (at end 2022).

The WFE is the definitive source for exchange-traded statistics and publishes over 350 market data indicators. Its free statistics database stretches back more than 40 years and provides information and insight into developments on global exchanges. The WFE works with standard-setters, policy makers, regulators, and government organisations around the world to support and promote the development of fair, transparent, stable and efficient markets. The WFE shares regulatory authorities' goals of ensuring the safety and soundness of the global financial system.

With extensive experience of developing and enforcing high standards of conduct, the WFE and its members support an orderly, secure, fair, and transparent environment for investors; for companies that raise capital; and for all who deal with financial risk. We seek outcomes that maximise the common good, consumer confidence, and economic growth, and we engage with policy makers and regulators in an open, collaborative way, reflecting the central, public role that exchanges and CCPs play in a globally integrated financial system.

If you have any further questions, or wish to follow-up on our contribution, the WFE remains at your disposal. Please contact:

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# Introduction

The WFE appreciates the opportunity to comment on the Proposed Rulemaking for Amendments to the Regulatory Capital Rule Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (the “Basel III Endgame” proposal) issued by the Federal Reserve Board of Governors (FRB), Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (the “agencies”) and the Proposed Rulemaking for Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies (the “GSIB Surcharge” proposal) issued by the FRB. The WFE and its members share the goals of supporting the safety and soundness of the US banking system, which is critical to supporting financial stability and investor confidence. However, the WFE wishes to highlight several concerns regarding the proposed changes, including concerns regarding whether these amendments will enhance resilience in the wider financial system, or incur negative knock-on effects on central clearing, particularly the cost of utilising clearing.

## Response

### The Basel III Endgame

On July 27<sup>th</sup> 2023, the FRB, FDIC, and OCC issued a notice of proposed rulemaking that would substantially revise the regulatory capital framework for US banks with assets of \$100 billion or more, as well as US banks with significant trading activity.

The Basel III Endgame proposal seeks to implement the final components of the Basel III framework. In addition, the proposal also seeks to enhance the resilience of the US banking system by modifying capital requirements for large banks in a more consistent manner. Overall, these proposals aim to:

- **Improve consistency of risk measurement**, by proposing to replace internal-models-based capital requirements for credit and operational risk currently included in Category I or II capital standards<sup>1</sup> with new, standardised requirements known as the “expanded risk-based approach” (ERBA).
- **Apply the capital standards to a broader set of large banks**, by proposing to require all banks with \$100 billion or more in assets to consistently calculate regulatory capital, including by highlighting actual loss-absorbing capacity in unrealised gains and losses on available-for-sale securities in regulatory capital. The proposal also would require such banks to meet supplementary leverage ratio requirements (ie a minimum amount of capital relative to exposures) and if needed, apply countercyclical capital buffers (a macroprudential tool that the agencies may decide to activate based on a range of macroeconomic, financial, and supervisory information).
- **Maintain stricter standards for US Globally Systemically Important Banks (GSIBs)**<sup>2</sup>, so that they are subject to a risk-based capital surcharge, as well as the enhanced supplementary leverage ratio.
- **Increase transparency of capital requirements**, by proposing to use standardised approaches and enhanced public disclosures to increase the comparability and transparency of capital requirements.
- **Provide a transition period**, by proposing to phase in the requirements over three years, with the new provisions proposed to be fully implemented in the fourth year after the effective date of the rule. The ERBA is proposed to be phased in over three years starting July 1, 2025, with the entire proposal proposed to be fully phased-in by July 1, 2028.

The agencies outline that these measures will result in an aggregate 16 percent increase in common equity tier 1 capital requirements for the affected banks.<sup>3</sup> Importantly, the proposal includes changes to the measurement of credit valuation adjustment (CVA) risk. CVAs are accounting adjustments made by banks to reserve some profits on uncollateralised financial

<sup>1</sup> See 12 CFR 3.2 (OCC), 12 CFR 252.5, 12 CFR 238.10 (Board), 12 CFR 324.2 (FDIC); “Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations,” 84 FR 59032 (November 1, 2019); and “Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements,” 84 FR 59230 (November 1, 2019).

<sup>2</sup> A bank is classified as GSIB when its failure would trigger a wider financial crisis. The Basel Committee on Banking Supervision (BCBS) has developed a formula for determining which banks are GSIBs, deploying criteria including size, interconnectedness and complexity - see Basel Committee on Banking Supervision, “*Global systemically important banks: assessment methodology and the additional loss absorbency requirement*”, <https://www.bis.org/bcbs/gsib>

<sup>3</sup> Federal Deposit Insurance Corporation (FDIC), “*Agencies Request Comment on Proposed Rules to Strengthen Capital Requirements for Large Banks*” <https://www.fdic.gov/news/press-releases/2023/pr23055.html>

derivatives and charge a counterparty to compensate for taking on credit risk during the life of a transaction. The proposal would replace the current approaches for measuring capital requirements for CVA risk for over-the-counter (OTC) derivative contracts with non-model-based approaches, and include the provision of client clearing within the CVA framework (ie when clearing members merely facilitate the clearing of trades for their clients, as opposed to house clearing of a member's own book). The proposal also calculates the services component of operational risk based on gross fees, as opposed to net fees.

## The GSIB Surcharge

The GSIB Surcharge proposal seeks to adjust to the calculation of the capital surcharge for GSIBs, aligning the surcharge to each bank's risk profile, and by measuring a bank's systemic importance over an entire year instead of by year-end value. The proposal would:

- Amend certain 'systemic indicators' within the interconnectedness, complexity, cross-jurisdictional activity, substitutability, and short-term wholesale funding categories;
- Reduce 'cliff effects' and enhance the sensitivity of the surcharge to changes in Method 2 scores by calculating surcharges based on narrower score band ranges; and
- Amend the Systemic Risk Report (FR Y-15).

In particular, the proposal looks to add the calculation of cleared OTC derivatives (where GSIBs act as agents for clients) to the Complexity and Interconnectedness indicators.

## The impact of the proposals on central clearing

CCPs play a key role in OTC derivative markets, particularly following the implementation of the 2008 mandate to centrally clear standardised OTC derivative contracts. Central clearing supports OTC derivatives' liquidity and efficiency as hedging tools for financial institutions and their clients. These proposed rule changes would increase the capital requirements for GSIBs who provide access to these markets and create negative knock-on effects impacting the individuals and businesses who rely on OTC derivatives to provide certainty and contribute to the real economy.

These knock-on effects would accumulate from several aspects of the proposals. The first issue is the proposed inclusion of client clearing in the CVA calculations in the Basel III Endgame proposal. This is because when clearing members facilitate clearing on behalf of their clients, they do so without assuming principal risk or adding the related transactions to their balance sheet. Therefore, the only counterparty credit risk-related loss that can be incurred via agency client clearing is that of an actual default, and this exposure is already covered by the counterparty credit risk default charge within standardised approach for counterparty credit risk (SA-CCR), which over-charges for counterparty credit risk. This ultimately results in a double charge to intermediaries of client clearing and highlights a misunderstanding from the agencies that clearing members do not keep this risk on their books, or that client default risk is included in SA-CCR.<sup>4</sup>

A second issue is the Basel III Endgame proposal to the services component of operational risk calculations, replacing the advanced measurement approach with the standardised measurement approach (SMA), which assigns capital according to the gross fees charged to the end-user, instead of the risk associated with the trade. This is not a global standard, and effectively amounts to a tax on clearing volume, rather than acting as a risk-mitigating measure. This proposal is particularly punitive on clearing members as a substantial percentage of the fees they charge to end-users are costs passed-through to and charged by other parties, rather than costs charged and retained by the clearing member itself.

Regarding the GSIB Surcharge proposal, the WFE questions the addition of the OTC client-cleared leg of the agency derivatives clearing model within the Complexity and Interconnectedness indicators. GSIB surcharges were introduced in the US in 2016 and represent an amount of capital that GSIBs must hold in excess of minimum requirements (ie an additional amount on top of the capital conservation buffer). This level varies in accordance with several systemic importance indicators, such as Complexity and Interconnectedness. Previously, these indicators have excluded client clearing transactions, but if they are included, it is estimated that this change will increase the capital requirements for client clearing by a significant extent.<sup>5</sup>

<sup>4</sup> In jurisdictions such as the UK and EU, regulators have exempted client-cleared derivatives from calculations due to banks being unable to suffer CVA-related losses.

<sup>5</sup> Risk.net, "Fed throws curveball with agency clearing surcharge proposal", <https://www.risk.net/regulation/7957498/fed-throws-curveball-with-agency-clearing-surcharge-proposal>

This change would also negatively affect the ability for clients to “port” their cleared transactions from one clearing member to another, as clearing members would be forced to factor in additional G-SIB surcharges when considering whether to purchase portfolios from each other.

WFE wish to reiterate that, following the G20 Leaders Declaration at the Pittsburgh Summit in 2009<sup>6</sup>, the use of central clearing has been advanced by policymakers across the globe, including US regulators, as a core part of managing risk and promoting stability in the financial system. Therefore, at a macro level, it is contradictory for the provision of central clearing to be included in measures which capture negative risks stemming from Complexity or Interconnectedness – in fact, its inclusion could increase systemic risk instead of reduce it, which is inconsistent with the objectives of both the GSIB Surcharge and commitments to central clearing. Furthermore, the use of a CCP reduces the number of counterparties a GSIB would be otherwise exposed to via bilateral derivative trades. CCP members are in fact less interconnected and should not be punished for this.

The WFE fundamentally disagrees with the notion that central clearing adds complexity to the financial system. It is universally understood that central clearing resolves a genuinely complex network of bilateral relationships into a single overview of the distribution of risk and simultaneously provides the benefits of multilateral netting, together with robust processes for ensuring that risk takers back their risk positions with multiple layers of resources. It should also be noted that the Basel Committee outlined in 2011 that “[t]he focus here is on the amount of OTC derivatives that are not cleared through a central counterparty. The greater the number of non-centrally cleared OTC derivatives a bank enters into, the more complex a bank’s activities.”<sup>7</sup> Other international regulators (such as in the UK and EU), outline that agency-model client clearing does not add to complexity indicator, and it is unclear why the proposals depart from this consensus. There is no justification for why client clearing should be considered a more-important indicator of complexity than other factors such as the number of subsidiaries, number of currencies payments are handled in, or number of exchanges of which a bank is a member. Moreover, notional amounts should not be used as a risk measure, as reflected in the statistics that the BIS gathers to highlight gross and net credit exposures, rather than a measure of cumulative market turnover represented by notional figures.

Given that the previously proposed requirement for banks to include cleared derivatives transactions to the calculation of GSIB surcharges via FR Y-15 Banking Organization Systemic Risk Reports<sup>8</sup> was not adopted, the WFE questions the rationale for attempting to implement similar changes once again. No evidence has been provided to suggest that the current proposals will rectify a material issue without causing a profound negative impact on cleared derivatives markets and increase systemic risk. This is important, as under the US Administrative Procedure Act, agencies “must explain the assumptions and methodology” underlying a proposed rule. Regulators should not lose sight of the bigger picture that central clearing should be encouraged, given that it is a tested mechanism that matches resources to risks, and provides benefits to the wider financial system.

Combined, the WFE believe the proposals, if adopted, will likely:

- **Increase consolidation<sup>9</sup> in the number of firms providing clearing**, if some derivatives clearing members respond to the proposed increase in capital costs by exiting the market.
- **Decrease the use of central clearing, by increasing barriers to entry to end-users** who wish to access centrally cleared OTC derivatives markets. This would occur due to:
  - o Increased costs passed on to end-users, who may then be forced to limit their activity or leave the market; and
  - o A reduced capacity offered by the remaining clearing members in the market (who could either be more willing to drop existing clients, or less-willing to take on new clients).
- **Increase prices in consumer goods and services**, as increased costs borne by clearing clients will be passed on in the form of higher prices for everyday items such as food and energy.

Measures which potentially reduce the number of clearing service providers in the market should be of concern to regulators, as the implementation of the G20 clearing mandate relies on clearing members to provide client access to CCPs, but there is no obligation for clearing members to do so. The provision of client clearing is low-risk and low-return for most intermediaries, and a

<sup>6</sup> Organisation for Economic Co-operation and Development, “G20 Pittsburgh Leaders Declaration”, <https://www.oecd.org/g20/summits/pittsburgh/G20-Pittsburgh-Leaders-Declaration.pdf>

<sup>7</sup> Basel Committee on Banking Supervision, “Global systemically important banks: Assessment methodology and the additional loss absorbency requirement”, <https://www.bis.org/publ/bcbs201.pdf>

<sup>8</sup> Federal Register, “Banking Organization Systemic Risk Report FR-Y-15”, <https://www.federalregister.gov/documents/2016/12/16/2016-29967/banking-organization-systemic-risk-report-fr-y-15>

<sup>9</sup> Commodity Futures Trading Commission, “Cleared Margin Reports”, <https://www.cftc.gov/MarketReports/ClearedMarginReports/index.htm>



significant increase to required capital will sharply reduce the viability of continuing to provide this service. For the GSIBs who can choose to continue providing access to centrally cleared markets to clients, they will be presented with a choice whether to raise costs or limit access to clients. The WFE believes that neither of these outcomes contributes positively to stability of the financial system.

One other knock-on effect that should be considered is the impact that these measures will have on market-makers and liquidity providers specifically, and in turn exchange-traded markets more broadly. As clearing capacity is constrained, market-makers could face limits on how much balance sheet they are afforded by banks facing larger capital requirements. The rules will also have an effect on aspects of the real economy, such as liquidity in energy markets and hedgers' costs, which could translate into higher energy costs for consumers. The WFE also wishes to highlight the importance of ensuring that the netting of exchange-traded exposures is adequately recognised to improve capital efficiencies. Specifically, we wish to share concerns about the limitations placed on banks' ability to net their exposures and decompose linear indexes, which will increase the capital requirements for using certain derivatives like options - important financial tools to manage exposures.

With this in mind, the WFE question the necessity of these proposals, which represent a deviation away from Basel III and from risk-based capital requirements. In going beyond implementation of the final components of the Basel III framework, the Basel III Endgame and GSIB Surcharge proposals will take the US out of alignment with international standards. The WFE believe that there is insufficient evidence to justify this, and that it is unclear as to what problem is being solved from going above-and-beyond the Basel III framework. If these proposals are implemented, US GSIBs affiliated clearing members will be at a disadvantage compared to other clearing members.

## **Conclusion**

In summary, the WFE believe that the proposed rulemakings are unjustified and would increase systemic risk in several ways, including by decreasing the access to derivatives clearing for hedgers such as manufacturers and agricultural businesses who would be less able to hedge their risks. We therefore urge the proposing agencies not to adopt the proposals. Broadly, any proposal, particularly one that could have systemic risk implications should be grounded in an adequate explanation of the rationale for the proposal and an evaluation of its potential impact on GSIBs, end users, cleared derivatives markets and the real economy.